VZCZCXRO7079
RR RUEHRG
DE RUEHBR #0327/01 0451929
ZNR UUUUU ZZH
R 141929Z FEB 06
FM AMEMBASSY BRASILIA
TO RUEHC/SECSTATE WASHDC 4534
INFO RUEHSO/AMCONSUL SAO PAULO 6372
RUEHRG/AMCONSUL RECIFE 4332
RUEHRI/AMCONSUL RIO DE JANEIRO 1537
RUEHBU/AMEMBASSY BUENOS AIRES 3786
RUEHMN/AMEMBASSY MONTEVIDEO 6049
RUEHAC/AMEMBASSY ASUNCION 5223
RUCPDO/USDOC WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 02 BRASILIA 000327

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USDOC FOR 3134/USFCS/OIO/WH/EOLSON
USDOC FOR 4332/ITA/MAC/WH/OLAC/MWARD
AID/W FOR LAC/AA

E.O. 12958: N/A
TAGS: EFIN ECON PGOV BR
SUBJECT: CONGRESS, INDUSTRY SEEK TO SEIZE THE INITIATIVE ON REFORM OF RULES GOVERNING FOREIGN EXCHANGE CONVERSION

¶1. (SBU) Summary. On February 8, Senator Fernando Bezerra (PTB-Rio Grande do Norte), leader of the government in the Senate, and President of the Senate, Renan Calheiros (PMDB-Alagoas) introduced a bill which, if passed, would liberalize the country's foreign exchange regime. The proposal was developed by FIESP (the Sao Paulo State Federation of Industries) in an effort to make Brazilian exporters more competitive in the international business arena and facilitate their expansion into world markets. Underlying this effort, which aims to reduce the amount of dollars converted in reals, are industry concerns that the current appreciated level of the real is undermining export competitiveness and profit margins. The current Brazilian foreign exchange system dates from 1933 (i.e., the era of former President Getulio Vargas). Analysts believe that reform of the foreign exchange conversion rules would help promote economic growth -- along with a more stable exchange rate. End Summary.

¶2. (U) Under the proposed bill:

-- Exporters would have the option of maintaining dollars or other foreign currencies in a domestic bank account, thus affording them the freedom to choose the best time to convert their money. Today exporters have a maximum of 210 days, as of the day of transaction, to exchange their dollars or other foreign currency to reals. (Prior to the previous round of reforms in 2004, the maximum time was 180 days.);

-- Domestic bank accounts denominated in dollars (or other foreign currencies) could be used to pay off overseas obligations where foreign currency is required and could receive payments arising from export transactions;

-- It would be prohibited to pay any real-denominated debt using a dollar-denominated bank account;

-- The National Monetary Council would regulate the opening and activity of dollar or other foreign currency-denominated accounts, as well as monitor how financial institutions use the foreign currency.

¶3. (SBU) Critics of the bill argue that, if enacted, the net effect of the measure would be negative. First, they argue that there would be more opportunities for money laundering due to the

difficulties of controlling the in-flow and out-flow of dollars or other foreign currencies. Second, they opine that such a law would make the banking system vulnerable as financial institutions would have large amounts of deposits in dollars and other foreign currencies. In the event of a sharp economic adjustment, exporters might be quick to move such dollar assets to more secure destinations overseas, with concomitant negative effects on the exchange rate and inflation. Last but not least, the new law would restrict the privilege of holding foreign currency accounts to a small group - i.e, exporters. However, it can be expected that other economic actors would seek the same rights, leading to a creeping dollarization of the economy.

¶4. (U) Former Central Bank President Gustavo Loyola has told the press that he opposes the measure principally because it would be wrong to authorize accounts to be held in a currency not issued by the Central Bank. That said, he also stated that fears of greater money laundering and/or capital flight were overblown. Meanwhile, Persio Arida, an economist and one of the creators of the successful Real plan in 1993-1994, has publicly stated that it would be good if passage of the foreign exchange liberalization bill led to increased influx and outflow of capital. According to Arida, this would send a strong signal to foreign markets that Brazil has transparent (and mature) capital markets and that Brazilian exporters are here to stay, thus diminishing perceptions of the risk of default.

¶5. (SBU) Comment. Given the fast-approaching October 2006 elections and the continuing preoccupation of the Congress with the ongoing influencing-peddling scandal, we do not anticipate much movement on the foreign exchange bill for the time being. Besides, even though the measure has the support of FIESP (a major lobbying power), which has led industry protests over what it considers the "over-valued" real, in Brazil successful legislation has traditionally originated

from the Executive Branch - and not individual senators/congressman themselves. And so far, neither the Central Bank nor the Ministry of Finance have weighed in on the merits of the bill. We do know, however, that in its 2004 redrafting of the foreign exchange rules, the Central Bank stopped well short of this level of liberalization.

CHICOLA